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China and the WTO: Chinese Legal Commitments and Their Effect on the U.S.-China Economic Relationship

Executive Summary

- Rather than focus on the size of the bilateral trade deficit, it would be better to evaluate the economic relationship between the United States and the People's Republic of China (PRC) in the context of the legal contract that governs it. That contract is the "United States-China World Trade Organization Accession Deal," signed by the Clinton Administration and Chinese negotiators in Beijing in 1999. Congress embraced that deal by granting Permanent Normal Trade Relations (PNTR) to China five years ago, enabling China to join the World Trade Organization (WTO).
- This paper evaluates the U.S.-China economic relationship in terms of China's performance in meeting its WTO obligations to participate in a rules-based trading system. As the paper demonstrates, in many areas of significant economic importance, the PRC has failed to fulfill its WTO obligations and has caused material harm to U.S. economic interests.
- China's obligations pursuant to the WTO trade agreement span eight broad subject areas, each of which includes many specific Chinese commitments to adhere to general WTO agreements and principles, as well as country-specific provisions requiring greater market access for foreign goods and services.
- Despite having only one WTO dispute filed against it, the PRC remains in violation of many critical WTO commitments, particularly those involving the protection and enforcement of intellectual property rights. Overall, China's commercial regulation remains overly opaque and oriented towards the growth of the export sector.
- This paper provides a report card to measure Chinese performance in meeting its WTO obligations (see pages 7 – 10).
- Congress and the Administration could take several steps in an effort to improve China's compliance with its WTO obligations. Specifically, the Administration could use the next affirmative International Trade Commission ruling to provide the affected industry with relief from Chinese imports and file several dispute settlement cases at the WTO regarding China's preferential tax and regulatory policies towards certain domestic industries. Congress could consider making a statutory change to allow the Commerce Department to apply countervailing duty law (duties assigned to offset illegal foreign subsidies) to non-market economies, such as China.

Introduction

The economic relationship between the United States and the People's Republic of China (PRC) is based on a legal contract, the "United States–China World Trade Organization Accession Deal," signed by the Clinton Administration and Chinese negotiators in Beijing in 1999.¹ That contract was embraced by the U.S. Congress the following year when it voted to grant Permanent Normal Trade Relations (PNTR) status to China (P.L. 106-286), removing the remaining obstacles for China to join the World Trade Organization (WTO) in December of 2001.²

Some analysts contend that the PRC's reform efforts have been impressive given the fact that China remains a non-market economy governed by the Chinese Communist Party."³ Yet, the WTO accession deal China signed contained specific, legally binding commitments, not qualitative judgments about whether the country was moving in the right direction. As such, the United States must take the steps necessary to aggressively assert its contractual rights and demand that China meet the letter – and spirit – of its obligations.

In the five years since PNTR for China was signed into law, the value of merchandise trade between the United States and the PRC has more than doubled to over \$230 billion in 2004.⁴ While U.S. exports to the PRC have grown by an impressive 113 percent since 2000, the bilateral trade deficit with the PRC has grown almost as rapidly, and is projected to surpass \$200 billion in calendar year 2005.⁵

Although many analysts have focused on the size of the trade deficit, bilateral trade relationships are the manifestation of a number of complex and interrelated factors such as relative prices, consumer preferences and savings rates, and capital flows.⁶ Focusing on the size of the deficit not only fails to capture many of these dynamics, but it also inappropriately applies a results-oriented, outcome-based approach to what should be a dispassionate legal analysis: is China playing by the rules that it originally committed to follow in 1999?

This paper attempts to answer that question by placing the U.S.-China economic relationship into its proper legal context. To that end, this paper constructs a report card to measure Chinese performance in meeting its WTO obligations to participate in a rules-based trading system. As the paper demonstrates, in many areas of significant economic importance, the PRC has failed to fulfill its WTO obligations and has caused material harm to U.S. economic interests. The paper concludes with steps Congress and the Administration should take to more forcefully address Chinese noncompliance.

¹ Congressional Research Service, "Trade Remedies and The U.S.-China Bilateral WTO Accession Agreement," CRS Report for Congress RS20570, August 4, 2003.

² WTO, "WTO Successfully Concludes Negotiations on China's Entry," WTO News, September 17, 2001.

³ U.S. Department of State, press release, "China Has Made Progress on WTO Commitments, But Problems Remain," December 14, 2004.

⁴ Bureau of Economic Analysis, International Economic Accounts, March 2005.

⁵ BEA.

⁶ Albert Keidel, "China's Currency: Not the Problem," Carnegie Endowment, Policy Brief No.39, June 2005.

Background

The WTO is a multinational organization formed through agreements negotiated and signed by a large majority of the world's trading nations and ratified by their governments. These agreements provide a legal framework for international commerce and serve as contracts that provide member countries with important trade rights and obligations that can be enforced in an international legal forum.⁷

The PRC first applied for membership in the WTO in July of 1986.⁸ At that time, trade between the PRC and United States was conditioned by a law known as the Jackson-Vanik amendment, which requires governments of non-market economies to reach a bilateral commercial agreement with the United States – on a yearly basis – before normal trade relations could be extended.⁹

During the 1990s, the Clinton Administration sought to end this annual review process by negotiating a permanent United States-China bilateral trade agreement. Negotiations resulted in a comprehensive agreement that required the PRC to reduce tariffs, eliminate export subsidies and quotas, and gradually open up service sectors (including distribution, telecommunications, insurance, and banking) to full and unfettered foreign competition.¹⁰ Congress ratified the agreement and ended the annual Jackson-Vanik review with passage of the legislation to grant PNTR in 2000.¹¹

The Economic Arguments for Granting PNTR to China

At the time of the PNTR vote, China's economy had been growing rapidly for 20 years following dictator Deng Xiaopeng's decision to ease price controls on agriculture and decentralize banking.¹² In Congress, PNTR supporters argued that the Chinese leadership had successfully learned the lessons of Deng's reforms – capitalist economic institutions and integration into the world economy – and now would embrace more complete economic integration with the rest of the world based on the free movement of goods and capital.¹³ Thus, PNTR would provide American industry access to the burgeoning Chinese market, while assisting China's economic transformation from a communist, command-and-control system to a market-based economy.

The Clinton Administration promoted China's WTO accession as a mechanism “to strengthen the rule of law in China and increase the likelihood that it [would] play by global rules as well.”¹⁴ Clinton officials argued that the deal would strengthen “our ability to ensure fair trade and to protect [the] U.S. agricultural and manufacturing base from import surges, unfair pricing,

⁷ The WTO was formally known as the General Agreement on Tariffs and Trade (GATT) until January 1, 1995. Information on the WTO and its agreements available at: <http://www.wto.org/>.

⁸ United States House of Representatives Committee Report 106-632.

⁹ Title IV of the Trade Act of 1974. Vladimir N. Pregelj, “The Jackson-Vanik Amendment: A Survey,” *Congressional Research Service Report for Congress 98-545 E*, August 22, 2003.

¹⁰ House of Representatives Committee Report 106-632 lists the ten specific market-opening requirements.

¹¹ P.L. 106-286.

¹² Professor Wing Thye Woo, “China: Facing up to WTO Membership,” *Center for International Development at Harvard University*, December 4, 2000.

¹³ Professor Woo.

¹⁴ “The U.S. – China WTO Accession Deal: A Strong Deal in the Best Interests of America,” The White House, March 8, 2000.

and abusive investment practices.”¹⁵ By “lock[ing] in detailed commitments in virtually every sector, covering industrial goods, services, and agriculture,” the agreement was expected to “expand our access to a market of over one billion people” and “give the United States broad new rights and strong mechanisms to enforce them.”¹⁶

Proponents of PNTR also contended that WTO accession would “be a key catalyst” for an “accelerated transition to free capital mobility in China.”¹⁷ This was important because the Chinese Communist Party (CCP) retained strict macroeconomic control over the economy’s overall direction even while the PRC allowed market incentives to begin taking hold on a microeconomic level. In particular, the PRC was using the banking system to finance PRC-sanctioned projects and industries by extending loans based on political, rather than economic, considerations.¹⁸

Supporters of PNTR argued that Chinese accession to the WTO was also necessary to reduce the bilateral trade deficit. In 1999, the U.S. trade deficit with China was \$68.7 billion.¹⁹ By ensnaring China in the contractual obligations of the WTO, proponents argued, Chinese markets would be more open to U.S. goods, thus diminishing the U.S. trade deficit. Economist Desmond Wong, China Director for Ernst & Young, echoed the sentiments of many when he argued that the WTO accession would lead the U.S. trade deficit with China to “narrow and eventually reverse...within five years.”²⁰ Jerry Jasinowski, president of the National Association of Manufacturers, concurred: “[The Chinese] are hungry for the opportunity to buy more American products and could become one of our largest trading partners within just a few years. These exports will create hundreds of good-paying jobs for U.S. workers.” Michael Rawding, Microsoft’s regional director for China, was similarly sanguine about U.S. export opportunities: “By the end of next year, China will probably rank as the third largest market in the world for personal computers.”²¹

Virtually all of the *economic-based* opposition to PNTR for China was provided by labor unions, including the United Auto Workers (UAW), AFL-CIO, and United Steel Workers of America (USWA).²² These organizations argued that increased trade with China would result in significant job losses as businesses shifted operations to take advantage of China’s seemingly endless supply of cheap labor.²³

¹⁵ The White House.

¹⁶ The White House.

¹⁷ Fred Hu, Managing Director – Goldman Sachs, “China’s WTO Accession as a Catalyst for Capital Account Liberalization,” *Cato Journal*, Vol. 21, No. 1, Spring/Summer 2001.

¹⁸ Caroline Gordon and Joshua Harman, “A Study of Two Entrance Issues: The Banking System and Intellectual Property Rights in China,” *Global Trade, Transportation, and Logistics Studies*, The University of Washington, May 24, 1999.

¹⁹ Foreign Trade Statistics, U.S. Census Bureau, available at: <http://www.census.gov/foreign-trade/balance/c5700.html#1999>.

²⁰ R.C. Longworth, “China Deal Doesn’t Guarantee a Fix for Deficit,” *Chicago Tribune*, July 5, 2000.

²¹ Nathaniel Harrison, “US business leaders jubilant over PNTR,” *AFP*, September 20, 2000.

²² Other opposition was mostly concerned with the international security, human rights, and internal political repression in China.

²³ Katharine Wheatley, “China in the WTO: Who’s in Favor and Who’s Opposed,” International Economics Study Center, April 19, 2001.

China's WTO Commitments and Their Review and Enforcement

China's WTO obligations span eight broad subject areas, each of which includes scores of specific Chinese commitments to adhere to general WTO agreements and principles, as well as country-specific provisions requiring greater market access for foreign goods and services.²⁴ A summary of the eight subject areas follows:

- **Trading Rights and Distribution Services** – The PRC agreed to grant full trade and distribution rights to foreign enterprises by the end of 2004 (with some exceptions, such as for certain agricultural products, minerals, and fuels).
- **Import Regulation** – Import regulations largely concern general and product-specific import tariffs. In addition to a number of specific tariff reductions, the PRC agreed to reduce the average tariff imposed on industrial goods and agriculture products from 24.6 percent and 31 percent to 8.9 percent and 15 percent, respectively (with most cuts made by 2004 and all cuts completed by 2010).
- **Export Regulation** – The PRC agreed to accept General Agreement on Tariffs and Trade (GATT) Article XI, which generally prohibits export restrictions other than duties, taxes or other charges related to the cost of administering an export regime. Exceptions are made for certain sensitive products, such as those whose export could compromise national security.
- **Internal Policies Affecting Trade** – The PRC agreed to abide by the core GATT 1994 principles of Most-Favored Nation nondiscrimination (known in the U.S. as normal trade relations) and national treatment, which requires that foreign firms operating in China would be treated no less favorably than Chinese firms for trade purposes, especially as such treatment relates to taxation, regulatory transparency, and price controls.
- **Investment** – The PRC agreed to eliminate local content and foreign-exchange-balancing requirements from its laws, regulations, and other measures. Importantly, the PRC also agreed that importation or investment approvals would not be conditioned on requirements such as technology transfer and export offsets.
- **Agriculture** – The PRC agreed to limit subsidies for agricultural production to 8.5 percent of the value of farm output and eliminate export subsidies on agricultural exports.
- **Intellectual Property Rights** – The PRC agreed to implement the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement immediately upon accession. The TRIPS agreement sets down minimum standards for most forms of intellectual property regulation – copyright and related rights, industrial designs, patents, trademarks, and trade secrets – within all member countries of the WTO.²⁵

²⁴ Loren Yager, "Observations on Ensuring China's Compliance with World Trade Organization Commitments," Government Accountability Office, GAO-05-295T, February 4, 2005.

²⁵ "Agreement on Trade-Related Aspects of Intellectual Property Rights," WTO: Annex 1C of the Marrakesh Agreement Establishing the World Trade Organization, signed in Marrakesh, Morocco on April 15, 1994.

- **Services** – The PRC agreed to open the banking system to full competition from foreign financial institutions by 2007. The PRC also agreed to permit various degrees of foreign ownership in joint ventures in insurance and telecommunications.

The PRC also agreed to accept a 12-year safeguard mechanism whereby other WTO members could unilaterally restrict trade in cases where a surge in Chinese exports cause or threaten to cause market disruption to domestic producers.²⁶ This safeguard applies to all industries, and permits the U.S. to act specifically against imports from China based on a lower showing of injury than is typically required.²⁷

WTO Compliance and Adjudication Mechanisms

The PRC agreed, as part of its WTO accession, to an annual review of its compliance with WTO obligations – the Transitional Review Mechanism (TRM) – during its first 10 years in the organization.²⁸ The TRM was to be a tool for maintaining pressure on China to comply with its market-opening commitments.²⁹ In addition, the PRC is subject to the Trade Policy Review Mechanism (TPRM), a form of monitoring applied to all WTO members, which will first occur for China in April 2006.³⁰ The United States Trade Representative is also required to produce an annual report on China’s WTO compliance, which serves as the official U.S. government assessment of China’s compliance record.³¹ The next USTR report will be released sometime this month.

Dispute Settlement Mechanism

As the WTO recognizes, “without a means of settling disputes, the rules-based system would be less effective because the rules could not be enforced.”³² The WTO rules concerning violations of obligations were set out in the 1986–94 Uruguay Round negotiations and agreed to by WTO members in the 1994 GATT agreement.³³ That agreement amended the original 1947 GATT to create a dispute settlement mechanism in response to concerns that the old procedure had no fixed timetables, allowed rulings to be blocked, and allowed many cases to drag on with no conclusion.³⁴

Before a dispute is referred to a panel appointed by the Dispute Settlement Body, the two parties to the dispute must consult for up to 60 days. If this consultation ends without a settlement, the aggrieved country can ask for a panel to be appointed.³⁵ Panels act as a tribunal to “try” cases. Either side can appeal a panel’s ruling to the WTO’s Appellate Body, a process that lasts 60 to 90 days. Once the appeal has concluded, if the country that is the “defendant” in the case loses, it will be given a “reasonable period of time” to end its illegal practices. If the country

²⁶ Wayne M. Morrison, “China-U.S. Trade Issues,” CRS Report B91121, November 3, 2005.

²⁷ Morrison.

²⁸ “U.S.-China Trade: Summary of 2003 World Trade Organization Transitional Review Mechanism for China,” Government Accountability Office, GAO-05-209R, January 25, 2005.

²⁹ GAO.

³⁰ “The TPRM review process,” World Trade Organization, *WTO Analytical Index: Trade Policy Review*.

³¹ 2004 Report to Congress on China’s WTO Compliance, United States Trade Representative, December 11, 2005.

³² The WTO, “Understanding the WTO: Settling Disputes.”

³³ WTO Legal Texts.

³⁴ Understanding the WTO: Settling Disputes.

³⁵ Understanding the WTO: Settling Disputes.

fails to take the necessary action within this period, it has to enter into negotiations with the complaining country (or countries) in order to determine mutually acceptable compensation. If no compensation can be agreed to, the aggrieved country may ask the Dispute Settlement Body for the right to impose sanctions, usually in the same sector as the disputed trade policy.³⁶

Once a final report is issued, the ruling of the panel (or Appellate Body) is automatically adopted unless there is a consensus of WTO members to reject a ruling. As of July 2005, only about 130 of the nearly 332 cases filed had reached the full panel process. Most of the remaining cases have either been settled “out of court” or remain in a prolonged consultation phase.³⁷

A Report Card for China’s WTO Compliance

Despite having only one dispute filed against it,³⁸ the PRC remains in violation of many critical WTO commitments. According to the United States-China Economic and Security Review Commission’s (USCC) 2005 Report to Congress, the PRC has “failed to make significant progress in the areas of noncompliance noted in the Commission’s 2004 Report to Congress.”³⁹ The USCC report also found that China has “effectively marginalized the WTO’s annual review of its progress in meeting its WTO accession commitments[,thereby,] preventing use of the TRMs as a means of putting multilateral pressure on China to account for compliance shortcomings.”⁴⁰ The USCC expects the WTO to produce a full accounting of the PRC’s compliance with its accession agreement when the TPRM review takes place next April.⁴¹

The following report card (with the grades issued by the Republican Policy Committee) is based on the annual USTR Report, the annual U.S. Chamber of Commerce review of China’s WTO compliance, and testimony to the USCC.

- **Trading Rights and Distribution Services – Grade Earned: C**

The PRC fell behind in liberalizing distribution services and direct selling in accordance with its WTO commitments, but has made significant changes in this area over the past two years.⁴² These changes led the U.S. Chamber of Commerce to note in its 2005 Report on China’s

³⁶ Understanding the WTO: Settling Disputes.

³⁷ Understanding the WTO: Settling Disputes.

³⁸ This dispute, formally launched in March 2004, concerned a value-added tax refund policy for integrated circuits and semiconductors that favored domestic Chinese producers. In this instance, the 60-day consultation resulted in the PRC agreeing to end its discriminatory practices to the satisfaction of the USTR, and no formal panel was necessary. “U.S. and China Resolve WTO Dispute Regarding China’s Tax on Semiconductors,” USTR, July 8, 2004.

³⁹ United States-China Economic and Security Review Commission (USCC) 2005 Annual Report to Congress, November 9, 2005.

⁴⁰ USCC, Annual Report to Congress.

⁴¹ USCC, Annual Report to Congress.

⁴² David Livdahl, and Zhongda Wu, “China’s Milestone Direct Selling Regulations,” China Law & Practice, October 1, 2005. , in mid-2004, issued regulations that eliminated national treatment and market access restrictions on joint ventures providing wholesaling services, commission agents’ services, direct retailing services and franchising services. China provided that liberalization would extend to wholly foreign-owned enterprises on December 11, 2004. On September 2, 2005, the PRC made public new rules, including the regulations for the administration of direct selling (effective December 1, 2005) that ended the seven-year ban on direct selling in China, and fulfilled the PRC’s WTO commitment to lift market access and national treatment restrictions in the area of sales away from fixed locations.

WTO implementation that the PRC “is largely in compliance with its trading rights commitments.”⁴³

However, the U.S. Chamber and USTR have expressed concern that China’s implementation of its distribution services commitments for wholly foreign-owned enterprises is lacking. The complex regulations and inadequate staffing levels of China’s Ministry of Commerce (MOFCOM) have led to a backlog of distribution rights licenses for the foreign businesses.⁴⁴ This has the effect of encouraging foreign businesses to engage in joint ventures in China to reduce their regulatory burden, which is a subtle form of reducing foreign competition.

- **Import Regulation – Grade Earned: B+**

According to the USTR, China has made all of the tariff reductions in agricultural and industrial goods as required.⁴⁵ The USTR fully expects China to comply with its pledge to eliminate tariffs on semiconductors and semiconductor manufacturing equipment, computers and computer parts, software, telecommunications equipment and computer-based analytical instruments by January 1, 2005. Future anticipated tariff reductions for passenger cars (reduced to 25 percent by July 1, 2006) and auto parts (reduced to 9.5 percent by July 1, 2006) also appear to be on track.⁴⁶

However, the USTR notes that China has not uniformly implemented its regulations with respect to valuation of goods imports at Chinese ports. As a result, some ports base the “dutiable” price of merchandise imports on a reference price instead of actual transaction value. In addition, some ports base the assessment of duties of digital media on the estimated value of the future copies instead of the value of the carrier medium itself (the difference in value between a blank DVD and a copy of “Harry Potter,” for instance).⁴⁷ Although these experiences have declined somewhat in 2005, the PRC must do more to make the import regime more uniform across ports.

- **Export Regulation – Grade Earned: D**

Export regulations, such as export quotas or restrictive export licenses, are intended to reduce the export of products – often, in China’s case, raw material inputs used in the production of finished goods – to protect a sensitive industry or to give domestic users of those products an unfair advantage. The USTR has found that, in many cases, China has charged export license fees well above the actual costs of administering an export license system. By setting fees well above the amount necessary to cover the costs of an export licensing regime, and setting quotas on the amount of allowable exports, China is able to artificially lower the price of such commodities for domestic users relative to the prevailing international price.⁴⁸

China pursued such a strategy in 2004 on blast furnace coke, a key input used for steel production. After the U.S. threatened a WTO complaint over such practices in April 2004, the

⁴³ “China’s WTO Implementation and Other Issues of Importance to American Business in the U.S.-China Commercial Relationship,” U.S. Chamber of Commerce, September 2005.

⁴⁴ U.S. Chamber of Commerce.

⁴⁵ USTR, 2004.

⁴⁶ 2005 National Trade Estimate Report on Foreign Trade Barriers, USTR.

⁴⁷ USTR, 2005.

⁴⁸ USTR, 2005.

PRC agreed to raise its quota allotment and to crack down on the illegal sale of export licenses. As a result, export prices declined and more coke was available for U.S. steel producers. Unfortunately, this did not represent a sea change in export control policy, as the PRC still subjects 50 categories of products to various types of export licenses and occasionally imposes new export licensing requirements on strategically sensitive commodities.⁴⁹

- **Internal Policies Affecting Trade – Grade Earned: D**

In a number of areas, China has employed policies that impose conditions on market access or give preferential treatment to domestic industries. Although the aforementioned discriminatory VAT tax on semiconductors was resolved bilaterally, the PRC continues to regulate and tax foreign firms differently than their domestic rivals beyond the extent allowable during the transition period. Specifically, the PRC has imposed price controls and reduced drug reimbursement on U.S. pharmaceuticals, slowed the testing of foreign products compared to domestic products, imposed discriminatory taxation, and imposed more cumbersome technical regulations on foreign products in areas where accepted international standards already exist.⁵⁰

- **Investment – Grade Earned: C**

Despite explicit commitments to end such practices, the PRC continues to embrace policies aimed at “encouraging” technology transfer. Instead of requiring such transfers as a condition of investment, which the PRC recognizes would be inconsistent with the WTO, the PRC has introduced various tax incentives for foreign investment in certain technology sectors. The USTR also found that Chinese officials still base investment approval decisions on the potential for export earnings.⁵¹ While China may not be in direct violation of the letter of its WTO commitments in this category, its policies to “encourage” technology-transfer and export growth often amount to outright requirements and represent *de facto* WTO violations.

- **Agriculture – Grade Earned: B-**

While China has become a growing market for U.S. agricultural exports, market access and regulatory transparency problems remain. China’s risk assessment regulations are overly restrictive as they are not based on sound science, while its labeling, import regulations, and inspection standards can often be difficult to comprehend and have slowed American exports to China.⁵² In July of 2005, the U.S. Department of Agriculture and China’s Administration of Quality Supervision, Inspection and Quarantine reached agreement on a Memorandum of Understanding to resolve these regulatory issues by increasing cooperation on animal and plant health safety issues.⁵³

⁴⁹ USTR, 2005.

⁵⁰ USTR, 2004.

⁵¹ USTR, 2005.

⁵² U.S. Chamber of Commerce.

⁵³ The U.S. – China Joint Commission on Commerce and Trade (JCCT) Outcomes on Major U.S. Trade Concerns, July 11, 2005.

- **Intellectual Property Rights – Grade Earned: F**

Although the PRC has revised its laws and regulations regarding patents, trademarks, and copyrights to comply with the TRIPS Agreement, it has failed to enforce these legal changes. As a result, piracy remains rampant in China and has had an enormous impact on U.S. business and the bilateral trade relationship. Although intellectual property protection is typically thought of in the context of media, entertainment, pharmaceuticals, and information technology, China's rampant piracy also includes unauthorized use of trademarks and patented designs, which has compromised U.S. businesses' brands and competitive positions in the markets for consumer goods, electrical equipment, and automotive parts, among others.⁵⁴

According to the International Anti-Counterfeiting Coalition (IACC), "China has no equal either as a source of counterfeit and pirated goods to the world or as a market in which fakes are produced and sold locally."⁵⁵ The USTR estimates that the rate of piracy and counterfeiting in China for certain types of products is about 90 percent, which is estimated to cost U.S. businesses between \$2.5 billion and \$3.8 billion annually.⁵⁶ Even more alarming, the U.S. Chamber of Commerce estimates that 70 percent of the pirated goods seized at the U.S. border in 2005 originated from China and Hong Kong.⁵⁷

To address U.S. concerns, in April of 2005, the PRC agreed to increase its enforcement of intellectual property rights by increasing prosecutions of pirates, reducing its infringing goods exports, and enhancing the coordination and enforcement powers of MOFCOM, the China Trademark Office, the State Intellectual Property Office, and the National Copyright Administration of China.⁵⁸ It is unclear to what extent this new bureaucratic arrangement will improve China's dismal performance in this area.

- **Services – Grade Earned: C**

In most services markets, including financial services, telecommunications, and construction and engineering, the PRC has generally made the legal changes it committed to, but has issued regulations that frustrate the ability of foreign firms to operate and compete inside China. Specifically, the USTR has noted that capital requirements and other rules to ensure prudential operations are set at levels far higher than what is common internationally.⁵⁹ Other restrictions, such as a lengthy approval process for branching, have led foreign firms to invest in local banks and insurers who have extensive networks and experience dealing with the Chinese regulatory system.⁶⁰ And while full banking liberalization is not mandated until 2007, the current level of bad loans and managerial dysfunction in the Chinese banking system suggests that it is highly unlikely that the PRC leadership will permit foreign banks to compete on an even playing field in 2007.⁶¹

⁵⁴ U.S. Chamber of Commerce.

⁵⁵ International Anti-Counterfeiting Coalition (IACC), Comments submitted to Trade Policy Staff Committee, September 15, 2004

⁵⁶ USTR, 2004.

⁵⁷ U.S. Chamber of Commerce.

⁵⁸ The U.S. – China Joint Commission on Commerce and Trade (JCCT) Outcomes on Major U.S. Trade Concerns, July 11, 2005.

⁵⁹ USTR, 2004.

⁶⁰ USTR, 2004.

⁶¹ Fred Hu, "The Truth About Investing in China's Banks," Financial Times, November 17, 2005.

Overall Assessment

Beyond China's WTO commitment-specific deficiencies, most observers continue to voice concern that China's regulatory regime continues to suffer from "systemic opacity."⁶² This opaqueness is due to the PRC's practice of frequently publishing regulations just as they are scheduled to take effect and often without a comment period.⁶³ Some foreign companies have complained of difficulty acquiring copies of laws and internal guidelines.⁶⁴

Although nearly every observer would agree that China has made substantial improvements, it appears that the Chinese Communist Party (CCP) leadership is still not oriented towards operating with the degree of transparency required by WTO accession. The PRC government rule remains capricious, as laws and regulations are often formulated secretly, applied inconsistently, and focused on the implementation of industrial policy priorities, such as increasing exports.⁶⁵

It should also be noted that while some of the PRC's WTO commitments, such as reducing tariffs and preparing reports, require easily verifiable actions, others are more complex.⁶⁶ For example, while the requirement for "nondiscrimination" in the treatment of foreign and domestic firms may be clearly understood and easily applied in relations between market economies like the U.S. and United Kingdom, this distinction is not as clear when applied to a Chinese economy still dominated by corruption-plagued, state-owned enterprises.

Similarly, whereas businesses in market economies use trademark-protected brand names to compete based on identification, China has no tradition of private property or strong brand identification.⁶⁷ Thus, negotiators were demanding that the PRC implement the complex WTO agreement on intellectual property protection at the same time its leadership was first allowing private citizens to own property and introduce branded product lines. None of this should absolve Chinese failure to comply with legal obligations, but it does suggest that American negotiators may have overestimated the PRC's readiness to accede to the WTO.

Improving China's Compliance

As noted earlier in this paper, the State Department has been impressed with China's reform efforts, given that China remains a non-market economy governed by the Chinese Communist Party. Yet, the WTO accession deal China signed contained specific, legally-binding commitments, and not merely qualitative judgments. As such, the United States must take the steps necessary to aggressively assert its contractual rights and demand that China meet the letter and spirit of its obligations.

⁶² USTR, 2005.

⁶³ Murray Hiebert, "China Gets a Passing Grade from Foreign Firms," *The Wall Street Journal*, November 28, 2005.

⁶⁴ Hiebert.

⁶⁵ U.S. Chamber of Commerce.

⁶⁶ Yager.

⁶⁷ "It is Patently Absurd to Try to Lock up the Chinese Copycats," *Financial Times*, July 19, 2005.

Over the past five years, the U.S. has largely relied on informal bilateral consultations and the annual meeting of the U.S.-China Joint Commission on Commerce and Trade (JCCT) to urge PRC officials to improve their WTO compliance efforts. While this approach has yielded some results, the U.S. must take further bilateral and WTO actions to address the problems that remain. Specifically, the U.S. should make use of the tools available under U.S. law and the WTO to combat unfair trade practices.

Use of China-Specific Safeguards and Possible Statutory Changes

As mentioned above, the PRC agreed to product-specific safeguards as part of its accession to the WTO. The United States allows aggrieved U.S. companies to petition the International Trade Commission (ITC)⁶⁸ when they believe imports from China have caused, or will cause, market disruption and material injury. Once the ITC makes an affirmative determination, the President decides what relief, if any, will be provided.⁶⁹

To date, of the six China-related petitions the ITC has received, it has rejected two and found that market disruption had occurred in four. Yet, in each of these four cases, the President elected to waive relief for affected industries.⁷⁰ While each of these determinations may have been wise when viewed in isolation, together they have created the appearance of a “predisposition against relief,” which could discourage future industry filings and actually embolden the PRC to delay the implementation of WTO market-opening obligations.⁷¹ The President would be wise to use the next affirmative ITC ruling to provide the affected industry with relief from Chinese imports. Such action would send a message to the Chinese that, if they do not meet their WTO commitments, the United States will use all means at its disposal to protect domestic industries from unfair trade practices.

Congress could also make a statutory change to apply countervailing duty law (duties assigned to offset illegal foreign subsidies) to non-market economies, such as China. Under current law, the Commerce Department does not apply countervailing duty laws to non-market economy countries where governments impose controls on prices and resources because “the process of constructing foreign market value for a producer in a non-market economy country is difficult and necessarily imprecise.”⁷² Yet, there can be little doubt that a major focus of the PRC’s industrial policy is to encourage the development of export industries, which is a de facto form of subsidization.

On July 27, 2005, the House of Representatives voted 255 - 168 to apply countervailing duty law to non-market economies and directly linked such action to the PRC’s compliance with its WTO obligations and subsidization of export industries.⁷³ If China persists in directing foreign

⁶⁸ The U.S. International Trade Commission is an independent, nonpartisan, quasi-judicial federal agency that provides trade expertise to both the legislative and executive branches of government, determines the impact of imports on U.S. industries, and directs actions against certain unfair trade practices, such as patent, trademark, and copyright infringement. Petitions are done in accordance with Section 421 of the Trade Act of 1974.

⁶⁹ China Safeguard investigations, International Trade Commission,

⁷⁰ The President has the statutory authority to waive relief in circumstances where the “provision of such relief is not in the national economic interest of the United States or, in extraordinary cases, that the taking of action. . . would cause serious harm to the national security of the United States.”

⁷¹ USCC, Annual Report to Congress.

⁷² *Sigma Corp. v. United States*, 117 F.3d 1401, 1407 (Fed. Cir. 1997).

⁷³ H.R. 3283, Section 5.

investment towards exporting sectors and subverting foreign competition, Congress should respond by empowering the Commerce Department to impose countervailing duties on Chinese exports.⁷⁴

WTO Dispute Settlement Cases

The USTR should file dispute settlement cases at the WTO in a number of areas where the PRC has failed to comply with its commitments. Since the problems experienced by U.S. firms are similar to those encountered by European and Japanese businesses, the USTR should coordinate dispute settlement case filings with EU and Japanese trade officials to the extent practicable.

Given the numerous areas of noncompliance outlined in the previous section, there are many dispute settlement cases the USTR could choose to bring. Yet, only one case has been filed since China's WTO entry in 2001. Although each case could take over 18 months from filing to conclusion, the USTR should, in conjunction with the EU and Japan, begin to aggressively file disputes until China has fulfilled each of its obligations. According to international lawyer, Terrence P. Stewart, there are several winnable WTO dispute settlement cases currently available to the USTR:⁷⁵

Export Regulation – China continues to impose illegal export restrictions on a number of strategically sensitive commodities. Specifically, the PRC continues to impose quotas and unjustifiably high license fees on exports of fluorspar – a key input for steel, aluminum, plastics, glass, ceramics, Freon, hydrofluoric acid, fiberglass, enamels and Teflon – despite continued requests from the USTR that China cease such practices.⁷⁶

Internal Policies Affecting Trade – China uses different tax bases to compute consumption taxes for domestic and imported products which has led the effective consumption tax rate on imported products such as tobacco, cosmetics, jewelry, and motorcycles to be substantially higher than the rate applied to domestic products. This discriminatory tax policy is illegal and deserves to be challenged.

Under China's standards testing regime, foreign products from some sectors are tested in specially designated laboratories that are separate from those laboratories used to test domestic products. This disparate testing has led to uneven treatment and should be challenged based on the principle of national treatment/nondiscrimination.

Agriculture – China also violates national treatment/nondiscrimination standards by applying certain non-science-based standards to raw poultry and meat imports that are not applied to domestic poultry and meat products.

⁷⁴ Although the House bill was focused on the alleged subsidies caused by the undervaluation of the Chinese currency, the Yuan Renminbi (RMB), the new enforcement powers contained in H.R. 3283 need not be focused on allegations of currency manipulation.

⁷⁵ Terrence P. Stewart, "China in the WTO: Year 3," USCC, January 21, 2005.

⁷⁶ USTR, 2005.

Financial Services – Foreign insurance firms must apply for permits for each additional branch that it intends to open. By contrast, the PRC has been issuing concurrent branch approvals (more than one at a time) for Chinese insurers.

Intellectual Property – The USTR should closely monitor the extent to which China's new JCCT commitments result in increased prosecutions, fines, and confiscation of pirated goods. Chinese compliance in this area has been abysmal and cannot be allowed to continue. The USTR must file a dispute resolution case with the WTO if the JCCT agreement fails to dramatically reduce internal piracy rates and exports of counterfeited goods.

Unconventional Strategies

If import safeguards, the application of countervailing duty law, and successive rounds of WTO dispute settlement cases fail to improve Chinese compliance, the Administration could employ more subtle tactics to condition Chinese behavior. For example, the PRC regularly refuses to issue visas to foreign officials who have voiced opposition to PRC policies (including members of the U.S.-China Economic and Security Review Commission), or represent governments that recognize Taiwan.⁷⁷ The PRC has also used the granting of commercial rights to fly over its territory as a diplomatic tool.⁷⁸

Since the PRC leadership has demonstrated its willingness to turn these legal formalities into a diplomatic weapon, the Bush Administration should consider doing the same. Chinese failure to comply fully with its WTO obligations could be tied to the denial of visas, the denial of airport landings or territorial overflights, a refusal of meetings, or the suspension of countless other routine bureaucratic courtesies extended every week.

Conclusion

While China has made progress in opening its economy, it remains in violation of many of the legal commitments it agreed to in 1999. As such, the United States must take the steps necessary to aggressively assert its contractual rights and demand that China meet the letter and spirit of its obligations. There are many steps Congress and the Bush Administration could take to make it clear to the Chinese that the American market will only remain open to those countries that play by the rules of the international trading system. Failure to take the steps necessary to hold China accountable may result in emboldening the PRC leadership to further delay compliance or even backslide on its commitments.

⁷⁷ "China Denies Visa to U.S. Group," United Press International, March 7, 2004.

⁷⁸ Canadian gets right to fly over China, The Financial Post, September 20, 1996.